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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-127740-04]

RIN 1545-BD46

Application of Section 367 in Cross Border Section 304 Transactions; Certain Transfers of Stock Involving Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed amendments to the regulations under section 367 relating to certain transfers of stock involving foreign corporations in transactions governed by section 304. Specifically, these proposed regulations provide that if, pursuant to section 304(a)(1), a U.S person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). These proposed regulations also provide that if, pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 acquisition is not an acquisition subject to section 367(b).

DATES: Written or electronic comments and requests for a public hearing must be received by August 23, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-127740-04), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to:

CC:PA:LPD:PR (REG-127740-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG-127740-04).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Tasheaya L. Warren Ellison, (202) 622-3870; concerning submissions of comments, Sonya Cruse, (202) 622-4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

A. Section 367(a)

A U.S. person's transfer of appreciated property (including stock) to a foreign corporation in connection with any exchange described in sections 332, 351, 354, 356, or 361 generally is treated under section 367(a)(1) as a taxable transaction, unless an exception applies. Congress enacted section 367(a) to prevent the avoidance of U.S. tax on transfers of appreciated property outside the United States in nonrecognition transfers involving foreign corporations. S.R. Rep. No. 169, Vol. 1, 98th Cong. 2d Sess., at 360 (Apr. 2, 1984).

In the case of a U.S. person's transfer of stock to a foreign corporation in an exchange described in section 367(a)(1), §1.367(a)-3 provides exceptions to the general gain recognition rule of section 367(a)(1), if certain conditions are satisfied

including, in some instances, the filing of a gain recognition agreement (GRA). See §1.367(a)-3(b) (transfer of stock in a foreign corporation) and (c) (transfer of stock in a domestic corporation).

B. Section 367(b)

Section 367(b) addresses transactions covered by sections 332, 351, 354, 355, 356, and 361 in which there is no transfer of property described in section 367(a). Section 367(b) provides that a foreign corporation shall be considered to be a corporation for purposes of these subchapter C provisions, except to the extent provided in regulations. The status of a foreign corporation as a corporation for these purposes may allow various participants to the transaction to qualify for nonrecognition treatment.

One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248. H. R. Rep. No. 94-658, 94th Cong., 1st Sess., at 242 (November 12, 1975). Section 1248 generally recharacterizes gain recognized by a U.S. person (a section 1248 shareholder) that owns 10 percent or more of the total combined voting power of a controlled foreign corporation, as defined in section 957, or, in certain instances, stock of a former controlled foreign corporation, upon the disposition of the stock of such corporation as dividend income to the extent of the earnings and profits that are attributable to such stock (section 1248 amount).

Consequently, §1.367(b)-4(b)(1) generally requires a section 1248 shareholder (or, in certain instances, a foreign corporation that has a section 1248 shareholder) to include in income its section 1248 amount as a result of certain section 367(b)

transactions, including certain section 351 exchanges, if as a result of the transaction section 1248 shareholder status or controlled foreign corporation status is lost.

C. Section 304

Section 304 was enacted to prevent withdrawals of corporate earnings by controlling shareholders in transactions that result in capital gains treatment. See H.R. Rep. No. 2014, 105th Cong. 1st Sess., at 465 (June 24, 1997). Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the acquiring corporation stock.

Prior to 1997, section 304(a)(1) provided that, to the extent of a distribution treated as a distribution to which section 301 applies, the issuing corporation stock would be treated as having been transferred by the person from whom acquired, and as having been received by the acquiring corporation as a contribution to the capital of the acquiring corporation. Section 304 was amended by section 1013 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 918) (August 5, 1997) to provide that, to the extent that a stock acquisition covered by section 304(a)(1) is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. Because the acquiring corporation is treated as

receiving the stock of the issuing corporation in a transaction to which section 351 applies, the transferor's basis in the stock of the issuing corporation carries over to the acquiring corporation under section 362.

In the case of an acquisition to which section 304(a) applies, section 304(b)(2) generally provides that the determination of the amount that is a dividend (and the source thereof) is made as if the property were distributed first by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits. In a transaction involving a foreign acquiring corporation, section 304(b)(5) may limit the amount of the earnings and profits of the foreign acquiring corporation that will be taken into account for purposes of section 304(b)(2)(A).

D. Application of Section 367 to Section 304(a)(1) Transactions

The application of section 367(a) and (b) to certain section 304(a)(1) transactions involving a foreign corporation has been addressed in various published guidance. See, e.g., Rev. Rul. 91-5 (1991-1 C.B. 114) (holding that section 367 applied to the deemed contribution to capital of target corporation stock under prior law because section 367(c)(2) resulted in the stock transfer constituting a section 351 exchange). Moreover, in the preamble to the proposed regulations regarding redemptions taxable as dividends (REG-150313-01, 67 FR 64331, October 18, 2002), the IRS and Treasury Department indicated that certain international provisions may apply to section 304(a)(1) transfers, and provided as an example the application of section 367 and the regulations promulgated thereunder to a deemed section 351 exchange involving foreign corporations. The IRS and Treasury Department also stated that further guidance on

the application of the international provisions to section 304(a)(1) transactions would be forthcoming.

The IRS and Treasury Department have determined that the policies underlying section 304 (prevention of withdrawals of corporate earnings through the use of transactions that result in capital gains treatment), section 367(a) (prevention of U.S. tax avoidance through transfers of appreciated property to foreign corporations), and section 367(b) (inter alia, preservation of the potential application of section 1248) are preserved if section 367(a) and (b) are not applied to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. In addition, the IRS and Treasury Department believe that the interests of sound tax administration are served by not applying section 367(a) and (b) to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. Consequently, these proposed regulations provide that section 367(a) and (b) will not apply to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. These proposed regulations do not address section 351 transactions other than those exchanges treated as section 351 exchanges by reason of section 304(a)(1).

1. Application of section 367(a)

In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares.

The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1), (3). Thus, the policy underlying section 367(a), which is to prevent the avoidance of U.S. tax on transfers of appreciated property to a foreign corporation in certain nonrecognition transactions, is maintained through the operation of subchapter C principles even if section 367(a) is not applied to a section 304(a)(1) transaction. Moreover, as discussed below, the application of section 367(a) to a section 304(a)(1) transaction may, in certain instances where the U.S. transferor files a GRA, result in a total income inclusion that is greater than the fair market value of the stock being transferred. The IRS and Treasury Department believe that this result is inconsistent with the policies of section 367.

For instance, in order to avoid recognizing gain on a section 351 transfer of appreciated foreign stock to a foreign corporation under section 367(a)(1), a U.S. person may be required to enter into a GRA. See §1.367(a)-3(b)(1)(ii). As noted, when a U.S. person transfers stock of a wholly owned foreign corporation (the foreign issuing corporation) to a wholly owned foreign acquiring corporation in exchange for property, section 304(a)(1) treats the U.S. person as having received foreign acquiring corporation stock in a deemed section 351 exchange, and then as having that stock immediately redeemed by the foreign acquiring corporation. If the U.S. person were to enter into a GRA, the application of section 367(a) to such a transaction will likely result in the GRA remaining in existence after the deemed redemption of the foreign acquiring corporation's stock. A U.S. person may, in fact, recognize income but, as a result of the GRA, not recognize any gain in the section 304(a)(1) transaction (e.g., the section 304(a)(1) transaction results in dividend income to the U.S. corporate transferor equal to

the consideration paid by the foreign acquiring corporation). In such a case, because the U.S. person has not recognized the inherent gain in the transferee foreign corporation's stock deemed to be received in the section 304(a)(1) transaction, the GRA will not be terminated. See §1.367(a)-8(h)(1) (requiring a transaction in which all realized gain (if any) is recognized currently to terminate a GRA). As a result, the U.S. transferor would remain subject to the GRA provisions contained in §1.367(a)-8. If the GRA subsequently were triggered pursuant to §1.367(a)-8(e) (e.g., if the foreign issuing corporation disposes of substantially all of its assets to an unrelated party during the 5-year GRA period), the U.S. transferor may be subject to a total income inclusion that is greater than the fair market value of the stock being transferred.

The application of section 367(a) to the transaction described above also results in administrative burdens for both the IRS and taxpayers. For instance, the conditions contained in §1.367(a)-3(b) and (c) require a determination of the value and class of stock either received by the U.S. person in the transaction or owned by the U.S. person immediately after the transfer. See, e.g., §1.367(a)-3(b)(1)(i) and (ii) and (c)(1)(i), (ii), and (iii). To the extent the transaction is described in section 304(a)(1), the foreign acquiring corporation does not actually issue any stock to the U.S. person. Therefore, in order to apply the above provisions, the IRS and taxpayers must make determinations based on the stock that is deemed to be issued by the foreign acquiring corporation.

For the reasons stated above, the IRS and Treasury Department have decided to exercise their regulatory authority under section 367(a) such that section 367(a) will not apply to deemed section 351 exchanges resulting from section 304(a)(1) transactions.

2. Application of section 367(b)

As discussed above in the preamble under heading B, §1.367(b)-4(b)(1) provides that, in the case of a section 351 exchange of stock of a foreign acquired corporation by a U.S. person that is a section 1248 shareholder of such corporation (or a controlled foreign corporation that has a section 1248 shareholder) to a foreign acquiring corporation, the section 1248 shareholder (or a controlled foreign corporation that has a section 1248 shareholder) must include in income its section 1248 amount, unless the requisite section 1248 shareholder status or controlled foreign corporation status is maintained immediately after the exchange. However, in a section 304(a)(1) transaction in which section 1248 shareholder status and controlled foreign corporation status is maintained immediately after the deemed section 351 exchange, such that there is no section 1248 inclusion, the transferor may be treated as receiving a dividend from the foreign acquired corporation pursuant to section 304(b)(2)(B). Thus, in a section 304(a)(1) transaction, some or all of the earnings that make up the section 1248 amount that section 367(b) seeks to preserve may be immediately included in income by the exchanging shareholder.

Additionally, application of §1.367(b)-4(b)(1) can, in some instances, create administrative burdens and be problematic. Section 1.367(b)-4(b)(1) requires a determination of the type and amount of stock received in the deemed section 351 exchange to determine whether the necessary section 1248 shareholder status and controlled foreign corporation status is maintained. Moreover, the application of §1.367(b)-4(b)(1) to a section 304(a)(1) transaction often can be problematic because the necessary section 1248 shareholder status and controlled foreign corporation status

may be treated as satisfied in the construct of the deemed section 351 exchange even though such status is immediately lost as a result of the deemed redemption transaction. For instance, the necessary section 1248 shareholder status and controlled foreign corporation status may be satisfied immediately after the deemed section 351 exchange when a U.S. corporation transfers a controlled foreign corporation (the foreign issuing corporation) to a foreign acquiring corporation in a section 304(a)(1) transaction, by taking into consideration the deemed issued stock by the foreign acquiring corporation. However, if both the U.S. corporate transferor and the foreign acquiring corporation are wholly owned by the same foreign parent, the necessary section 1248 shareholder status and controlled foreign corporation status will not be satisfied immediately after the deemed redemption transaction.

For the reasons listed above, the IRS and Treasury Department have decided to exercise their regulatory authority under section 367(b) such that section 367(b) will not apply to deemed section 351 exchanges resulting from section 304(a)(1) transactions.

E. Request for Comments

Section 304(b)(6) grants the Secretary authority to prescribe regulations that are appropriate in order to eliminate multiple inclusions of any item of income by reason of section 304(a) and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961) in section 304(a) transactions in which the acquiring or issuing corporation is a foreign corporation. The IRS and Treasury Department are considering whether to issue regulations under section 304(b)(6) to adjust (1) the acquiring corporation's basis of the issuing corporation stock it acquires in the transaction, and (2) the transferor's basis of the issuing corporation stock in

situations in which the transferor continues to own issuing corporation stock immediately after the transaction, to the extent that the transferor is treated under section 304(b)(2)(B) as receiving a distribution from the earnings and profits of the issuing corporation. Comments are requested regarding how such adjustments should be made, particularly if different classes of issuing corporation stock are acquired or retained in the section 304(a)(1) transaction. Comments also are requested as to how, and to what extent, these types of adjustments should be made outside the context of section 304(b)(6) (e.g., in a section 304(a)(1) transaction in which both the acquiring corporation and issuing corporation are domestic corporations).

Effective Dates

The proposed regulations are proposed to apply to section 304(a)(1) transactions occurring on or after the date of publication of these regulations as final in the **Federal Register**.

Effect on other Documents

If these proposed regulations are adopted as final regulations, Rev. Rul. 91-5 (1991-1 C.B. 114) and Rev. Rul. 92-86 (1992-2 C.B. 199) will be modified to the extent inconsistent with such final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because these regulations do not impose a collection of information on small

entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Tasheaya L. Warren Ellison, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.367(a)-3 is amended as follows:

1. A sentence is added to paragraph (a) immediately following the second sentence.
2. The new fourth sentence of paragraph (a) is amended by removing the language “However” and adding “Additionally” in its place.
3. The first sentence of paragraph (e)(1) is removed and two sentences are added in its place.

The revision and additions read as follows:

§1.367(a)-3 Treatment of transfers of stock or securities to foreign corporations.

(a) In general. * * * However, if, pursuant to section 304(a)(1), a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). * * *

* * * * *

(e) Effective dates. (1) In general. The rules in paragraphs (a), (b) and (d) of this section generally apply to transfers occurring on or after July 20, 1998. However, the third sentence of paragraph (a) of this section shall apply to section 304(a)(1) transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**. * * *

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Par. 3. In §1.367(b)-4, a sentence is added to the end of paragraph (a) to read as follows:

§1.367(b)-4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) Scope. * * * However, if pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not an acquisition subject to section 367(b).

* * * * *

Par. 4. Section 1.367(b)-6 is amended by revising paragraph (a)(1) to read as follows:

§1.367(b)-6 Effective dates and coordination rules.

(a) Effective date--(1) In general. Sections 1.367(b)-1 through 1.367(b)-5, and this section, generally apply to section 367(b) exchanges that occur on or after February 23, 2000. However, the last sentence of paragraph (a) in §1.367(b)-4 shall apply to section 304(a)(1) transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

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Cono R. Namorato

Acting Deputy Commissioner for Services and Enforcement.